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Mr Chairman, Members of the Committee,
Thank you for inviting me today to give an analyst's view of the Telecommunications Act of 1996. My name is Tod Jacobs, and I'm the senior telecommunications services analyst at Sanford C. Bernstein & Company, in New York. In this capacity, I spend my time forecasting the short-term and long-term earnings of local and long distance companies, and advising institutional money managers globally on the stocks in the telecom sector. We are currently recommending both AT&T and several RBOCs, and my comments today summarize ideas we have been writing about and or sharing with clients over the past year.

In a sense, the Telecommuncations Act was destined to be flawed. The reason, in our opinion, was that the starting point for the Act was the Modified Final Judgement, which was itself ill-conceived in the way it broke up the Bell system. The reason is simple: divestiture split up two businesses that are in many ways not meaningfully distinguishible: local and long distance. That is: distance is not a meaningful divider of telephony products, neither in the mind of the user nor in the behavior of network costs. The industry's move toward packet switched data products will only exascerbate the problem. Indeed we would argue that the artificial divide along local and long distance lines has done much to hurt the competitiveness of the large incumbent companies on both sides of the business, and has distorted pricing for end users for more than a decade. Nor has the sharing of regulatory responsibilities between the states and federal government produced much in the way of efficiency. A more enlightened approach might have been to divide AT&T into several vertically integrated regional companies that could have trully gone head to head without further regulation. But that's so much spilled milk.

With the MFJ and its restrictions a starting point, I believe that the conceptualization of the Act itself was reasonably well balanced in its attempt to open the local exchange, and in return to offer long distance entry. The transition from concept to reality would prove more challenging. And it is our belief that in its approach to the Interconnection Order of August 1996, which would put the flesh on the bones of the Act, the FCC created a path to the opening of the local markets that was untenable from the point of view of the RBOCs, and thus doomed to morass. There were two primary causes. First, the FCC attempted to mandate the pricing mechanism for unbundled network elements known as TELRIC, which doesn't allow for the recovery of embedded costs through the pricing of unbundled elements. Second, the Commission attempted to mandate so-called "rebundling" of network elements at TELRIC prices. In our opinion, rebundling looks like resale, smells like resale and sounds like resale. But whereas resale discounts appear to be averaging about 20%, we believe that rebundling at TELRIC produces discounts of about 35% on average residential customers and closer to 55% on average business customers, with good customers would producing discounts of 70% or more. Thus armed, AT&T, MCI and Sprint were positioned to swoop down upon the local marketplace, take substantial market share, undercut RBOC prices and still make a meanginful profit -- all without investing substantial capital.

Any notion that the RBOCs would view rebundling as a good trade for long distance would prove fallacious. Here's the math: the local business that's becoming competitive totals about $90 billion in annual revenue. The long distance business is about $85 billion. So at first glance they're more or less the same. The problem from an RBOC standpoint stems from two issues: the size of the addressible market opportunity in long distance, and the relative profitability of long distance. First off: you can start with $85 billion in long distance revenue, but you have to pull out about $20 billion in switched access charges that are not a new revenue opportunity for the RBOCs since it's already included in the $90 billion in local revenue. Then you can pull out an additional $20 billion in products that the RBOCs won't be able to compete for since they'll enter long distance as resellers, not as network owners. Thus the true addressible market opportunity for RBOC long distance is closer to $45 billion, or about half the size of the core local market. Relative to profitability, under an FCC-inspired pricing scenario -- complete with rebundling at TELRIC -- we estimate that for every dollar of revenue the RBOCs lose at retail, the corresponding loss of cash flow would be about $0.40. On the other hand, for every dollar won in the long distance arena, the RBOCs would be lucky to drive cash flow of $0.10. That is, the RBOCs would have to win $4 of long distance for every $1 lost in local just to break even. Adjusting for the size of the two markets, it turns out that an RBOC would have to win 6-8 points of market share in the addressible long distance market for each 1 point it lost in local in order to stand still. In my business, that's not the makings of a good trade.

Thus the RBOCs did the only reasonable thing: they chose not to be proactive about getting into long distance, and they went to court to change the rules. And while the 8th Circuit Court is viewed by some as having impeded competition, we would contend that it has simply helped to level the playing field. There are two roads to competition: a stable transition and an unstable transition. The FCC path was, in our opinion, destined to produce instability, since in essence it would have produced intensive cream skimming of the local markets rather than a long-term path to a healthy, globally competitive industry. The path that has developed with the help of the Eight Circuit is rather more stable, since the only players under the current setting who can enter the local market are those willing to commit capital, such as the competitive local exchange carriers, or CLECs.

Still, we are left with two problems: one with respect to the RBOCs, and another with respect to AT&T.

First the RBOCs:
Unlike many countries across the globe who are opening their markets to competition, the United States did not rebalance rates before opening the doors to competitiors. Let’s be clear, the RBOCs have above-cost urban rates and above-cost business rates because we as a nation decided long ago that rural and residential rates should be low. But that pricing distortion only works in a vacuum. In our opinion it is not reasonable to mandate distorted pricing and then to throw the doors open to competitors whose only incentive will be to target the urban business customers -- and with them nearly all the RBOC profits -- while saddling the RBOCs with the rural and the residential. That’s to say nothing of the notion that the RBOCs are enjoined from offering an equivalent full slate of products being offered up to business customers by the CLECs. And again to say nothing of the fact that the RBOCs have yet to be granted the pricing flexibility to compete against the cream skimmers strategically. In the end, it depends what you want to produce through competition: a globally competitive vertically integrated industry with incentive to invest in new services, or cream skimming, falling investment long term, and thus lower prices and better services only for a small group of business users, while residential users are left behind.

And Relative to AT&T:
Looking to the other side of the aisle, we believe that AT&T is also left in an untenable position. That is, without a viable entry strategy to address residential customers -- another problem that would be largely solved through rebalancing of the RBOC rates -- the company is highly exposed to customer loss as the RBOCs enter the long distance business. That’s because it’s a lot easier to add long distance services to an existing local customer than to add local services on top of the long distance, as the cases of GTE and SNET demonstrate. Moreover, AT&T is being hamstrung by regulators relative to any conceivable strategy that would save it long term, such as a natural merger with an RBOC. And all the while the smaller competitors -- some of whom are no longer so small -- are free to assemble vertically integrated sets of local, long distance and internet assets. Thus from the AT&T perspective it would be less than reasonable to allow for RBOC long distance entry too quickly.

What to Do?

It is clear to us that the current structure of US telecommunications as well as the unfolding process of micromanagement surrounding it is far from ideal, though as we've noted, we believe that the 8th Circuit's weighing in has at least helped. As to a long-term workable solution that would be both equitable to the companies as well as to the vast majority of business and consumer end users, we've advised our clients to look for signs that regulators are prepared to rebalance rates once and for all by lowering business, access, toll and vertical service rates and raising residential rates; and by geographically de-averageing rates. In addition, the pending universal service platform offers the opportunity to redistribute revenues in a way that reflects costs, and therefore trades the cream skimming of a small set of customers in favor of making all customers, residential and business, rural and urban, attractive to competitiors. Then we could throw away the rules, allow the RBOCs into long distance, allow vertical mergers between the likes of Sprint or AT&T with the likes of SBC or Bell Atlantic. What would develop would be 3-5 powerhouse companies. Which would of course spur the cable companies to rebuild more quickly to assure their own long term future, as well as to make possible cross-regional local competition. And wireless companies companies, too, would play a role in bringing new services to bear.

Thank you again for your time and for the opportunity to express our views.